Private Equity Primer

by David M. Toll, Managing Editor, Private Equity Analyst, Dow Jones & Company

Introduction

Widespread use of the phrase "private equity" dates back to the late 1980s, after Hollywood had taken its turn socking leveraged buyout firms in the stomach.

Probably they deserved it. For most of the decade, leveraged buyout firms had routinely tried to profit by shattering the companies they had acquired into pieces and then selling off the shards. The theory was that by busting companies apart, a firm could awaken buyers to the true value of a company's assets, and then profit from their sale, one by one. The strategy proved a financial success, but a public relations debacle. By the late-1980s, the business press was regularly lambasting leveraged buyout firms for what they perceived as their rampant greed and arrogance.

The crowning blow came in 1987, when the movie Wall Street cemented in people's minds the image of the callous financial buyer (Gordon Gecko, played by Michael Douglas) taking over companies simply to sell off their assets, at the expense of blue-collar jobs. "Greed is good," Mr. Gecko cynically told his fictional shareholders.

By the early 1990s, few leveraged buyout firms were pursuing "buy-and-bust" strategies anymore. But the damage to their image had been done. Many leveraged buyout shops decided that the answer was to call themselves something new. They settled on "private equity firms"—an innocuous sounding moniker that, as with most euphemisms, is less descriptive, and more ambiguous than the phrase it replaced.

For buyout firms, the attempt to rename their business was only a partial success. The press by and large still refers to leveraged buyout firms as leveraged buyout firms, or LBO firms. However, firms did succeed in getting "private equity" into the lexicon. Some people, as it was intended, use the term private equity as a synonym for leveraged buyout. More commonly, however, people use private equity in a broader sense, as we do, to describe any investment strategy that involves the purchase of equity in a private company. Along with leveraged buyouts, these strategies include venture capital investments, distressed debt investments and mezzanine debt financings.

The private equity market has experienced unprecedented growth during the past decade, and it is still growing.

From 1991 through 2001, venture capital, LBO and other private equity firms raised record amounts of money each year to finance private, entrepreneurial companies. Fundraising slowed in 2002 and 2003, but rose again in 2004. The rise in capital raised and deployed has been astounding. In 1991, private equity firms raised just $8 billion for their investments from individual and institutional investors. By 1999, private equity firms succeeded in raising more than 10 times that amount, $95.5 billion, on the strength of double-digit investment returns through much of the decade.

The companies that private equity firms finance span the spectrum of technologies, from cutting-edge medical and Internet start-ups to established, old-line manufacturing companies. They include service companies as well, such as retail stores, health care management companies, money management firms and similar businesses. The common denominators: sophisticated financial investors, highly motivated owner-managers, and the opportunity for both to earn exceptional investment returns.

The first section of this primer is devoted to defining the various sub-specialties within private equity (leveraged buyouts, venture capital, mezzanine debt/distressed debt, funds-of-funds and secondary purchases). A question-and-answer section addressing fundamental questions about this fast-growing class of alternative assets follows that. The final section is a glossary of terms commonly used by private equity firms and their investors.

Leveraged buyouts

Leveraged buyout firms specialize in helping entrepreneurs to finance the purchase of established companies. The approach of such firms is to provide a management team with enough equity to make a small down payment on the purchase of a business, and then to pay the rest of the purchase price with borrowed money. The assets of the company are used as collateral for the loans, and the cash flow of the company is used to pay off the debt. Because the acquired company itself is paying the freight for its own acquisition, these investments were originally known as “boot-strap” deals. Eventually they became known as leveraged buyouts, or management buyouts.

The LBO business has changed dramatically since the buy-and-bust days of the 1980s. Largely because companies today are so highly priced, the buy-and-bust approach rarely works anymore. In addition, banks and other lenders today are much more conservative about lending money for leveraged buyouts.

As a result, buyouts today are financed with more equity. And the companies acquired are usually divisions being sold by corporations that are refocusing on their core businesses, or businesses owned by families who wish to cash out. To earn an attractive return on their investment, LBO firms today must build value in the companies they acquire. Typically, they do this by improving the acquired company’s profitability, growing the acquired company’s sales, purchasing related businesses and combining the pieces to make a bigger company, or some combination of those techniques. One of those most popular techniques these days is the consolidation, or “buy-and-build.”

The consolidation is the polar opposite of the buy-and-bust. It involves not the breaking up of large companies, but the merging of small ones into an organization that, in theory at least, equals more than the sum of its parts. Buyout firms pursuing consolidations have any number of ways of increasing their returns—through leverage, through cost-cutting measures, and through internal growth. They also can benefit from the fact that small companies, because they attract fewer potential buyers, generally command lower purchase multiples than large companies. Consolidators can therefore pay low multiples of cash flow on the companies they buy, but sell the large company they create at high multiples—depending, of course, on market conditions.

An estimated 450 LBO firms ply their trade in the United States today. In 2003, 76 of them raised $37.4 billion for fresh investments, up from the $24.8 billion raised by 59 firms in 2002, but way down from the record $63.5 billion landed by 117 firms in 2000. However, as 2004 wound to a close, it appeared that the record could at least be threatened and perhaps even broken. The pick up in buyout fundraising is tied in part to the strong environment that buyout firms have found for deals over the past year as well as the growing interest by institutional investors in private equity as a whole.

Venture capital

Risk capital for starting, expanding and acquiring companies is critical for any economy to grow. During most of the history of the United States, the market for arranging such financing was fairly informal, relying primarily on the resources of wealthy families. But, after the Second World War, the system started to change. Specialized investment management firms began to be formed with the specific purpose of financing start-up companies that entrepreneurs were launching.

Two of the earliest such firms were Boston-based American Research & Development Corp. and Connecticut-based J.H. Whitney & Co. ARD's best known investment was the start-up financing it provided in 1958 for computer maker Digital Equipment Corp. One of J.H. Whitney's seminal investments was financing that helped to transform a military technology intended to provide a nutritious beverage for troops in the field into a product that today is a household name: Minute Maid Orange Juice.

The number of such specialized investment firms, eventually to be called venture capital firms, began to boom in the late 1950s. The growth was aided in large part by the creation in 1958 of the federal Small Business Investment Company program. SBICs are federally licensed venture capital firms that can borrow money with a government guarantee of repayment. That guarantee allows SBICs to raise money inexpensively. They must then invest the money in entrepreneurial companies. Hundreds of SBICs were formed in the 1960s, and many remain in operation today. They have been surpassed in number, however, by more than a thousand independent private venture capital companies that don't rely on government support.

During the 1960s and 1970s, venture capital firms focused their investment activity primarily on starting and expanding companies. More often than not, these companies were exploiting breakthroughs in electronic, medical or data processing technology. Early successes include, for example, Intel Corp., Apple Computer Corp., Lotus Development Corp., Genentech Corp. and Federal Express Corp. As a result, venture capital came to be almost synonymous with technology finance.

Today, an estimated 900 venture capital firms in the United States raise outside capital from individual and institutional investors to finance their activities. Most are quite specialized, often investing in a single field, such as telecommunications or health care, and often only in one section of the country, such as the San Francisco Bay area, or Texas.

Venture capital firms also tend to specialize by stage of investing. There are no hard and fast definitions for these stages. Roughly speaking, however, seed-stage firms tend to provide a few hundred thousand dollars, and perhaps some office space, to an entrepreneur who needs to flesh out a business plan. Early-stage investors back companies at a point where they have a completed business plan, at least part of a management team in place, and perhaps a working prototype. Late stage-round investors typically provide a second or third-round of financing, often of $10 million or more, that funds production, sales and marketing, and carries the company into the revenue-producing stage. Mezzanine, or pre-IPO-stage, investors provide a final round of financing that helps carry the company to an initial public offering.

The advent of the Internet as a new medium for both personal and business communications and commerce created an avalanche of opportunities for venture capitalists in the mid- and late-1990s. As a result, the industy experienced extraordinary growth, both in the number of firms and in the amount of capital they have raised. In 2000, the VC industry raised close to $100 billion. In recent years, those numbers have come down, but were back on the rise in 2004.

Mezzanine debt/distressed debt

The mezzanine debt and distressed debt specialties of private equity share characteristics of both private debt and private equity financing.

Just as mezzanine seating is in the middle balcony of a theater, mezzanine debt firms provide a middle level of financing in leveraged buyouts—below the senior debt layer and above the equity layer. A typical mezzanine investment includes a loan to the borrower, in addition to the borrower's issuance of equity in the form of warrants, common stock, preferred stock, or some other equity investment. Often, the loan is contractually subordinated to a loan made by one or more senior secured lending institutions. Typically, the note evidencing the loan has a maturity of between six and 10 years, with interest paid only during the first five years. Because the loan is subordinated, the interest rate is generally is higher than the rate on the senior debt, and a limited amount of equity is issued to the mezzanine investor for nominal consideration.

Mezzanine investments have been used extensively to help fund the purchase and recapitalization of private, middle-market companies. Mezzanine investors also invest in smaller public companies and in foreign entities. Often, the borrower is highly leveraged after the investment is made.

Because mezzanine investments include both debt and equity portions, mezzanine investors have defied the traditional classifications of lenders, on the one hand, and equity investors, on the other. The flexible nature permits a mezzanine investor to emphasize the capital preservation and current-pay features of a loan and, at the same time, seek significant upside on its investment through the equity participation.

It is the combination of the two features which form the economic rationale for the investment, and which justifies investor involvement in the mezzanine market. The subordination of the loan creates risk that cannot be compensated solely by the coupon on the debt. The equity portion should provide enough upside potential to make the mezzanine investment attractive to the investor. The mezzanine investor has determined not to take equity risk, otherwise it would buy only equity securities and price the investment for an equity return.

Distressed debt firms, as their name implies, buy corporate bonds of companies that have either filed for bankruptcy or appear likely to do so in the near future. Their penchant for seeking out highly troubled companies has led some in the financial press to refer to them as "vulture capitalists." The unflattering metaphor only goes so far, however. Distressed debt firms do, of course, sniff out the sick and weak. But they generally have no taste for carrion. They make their highest returns not by liquidating a company, but by nursing it back to health.

The strategy of distressed debt firms involves first becoming a major creditor of the target company by snapping up the company's bonds at pennies on the dollar. This gives them the leverage they need to call most of the shots during either the reorganization, or the liquidation, of the company.

In the event of a liquidation, distressed debt firms, by standing ahead of the equity holders in the line to be repaid, often recover all of their money, if not a healthy return on their investment. Usually, however, the more desirable outcome is a reorganization that allows the company to emerge from bankruptcy protection. As part of these reorganizations, distressed debt firms often forgive the debt obligations of the company, in return for enough equity in the company to compensate them. (This strategy explains why distressed debt firms are considered to be private equity firms.)

Unburdened of the interest payments on the forgiven debt, the company becomes better positioned to rejuvenate itself. In addition, distressed debt firms typically employ people expert in effecting "workouts," or company turnarounds. When the newly healthy company is later sold or taken public, distressed debt firms stand to profit handsomely from cashing out their equity positions.

Both mezzanine debt and distressed debt strategies are far less common than leveraged buyout and venture capital investing.

Funds-of-funds

For any number of reasons, investing directly in private equity funds can be difficult—particularly for individual investors and small institutional investors.

Information about the performance of private equity managers is hard to come by. Gaining access to what are perceived to be the top-performing venture capital and buyout funds is problematic, since the fund managers often have more demand for their funds than they can accommodate.

Finally, the relatively high investment minimums that fund managers generally require—$20 million isn't uncommon for a large buyout fund—make it challenging for a small institutional or high-net-worth investor to gain sufficient diversification.

For these and other reasons, private equity funds of funds have grown rapidly in popularity during the past few years. The fund of fund manager co-mingles the investments of many small investors into a single pool, then uses it to assemble a portfolio of private equity funds. The minimum commitment to a fund of funds for individual investors is often in the $250,000 to $500,000 range—a single, manageable investment that gives investors an instantly diversified set of private equity investments. As the fund of funds industry has matured, managers have begun creating more specialized investment pools that provide investors with more targeted exposure—say, for example, to a portfolio of venture capital funds. For this reason, even many large institutional investors have found the fund of funds to be a useful vehicle for giving them additional exposure to areas of private equity in which they have been under-weighted.

The main drawback of investing in a fund of funds is the added layer of fees. Fund of fund managers generally charge in the neighborhood of a 1 percent annual fee for their services. Many also take a small carried interest, or share of profits, in the 5 percent to 10 percent range. This layer of fees is in addition to the management fees (typically 1.5 percent to 2.5 percent) and carried interest (typically 20 percent to 30 percent) charged by the underlying fund managers.

Secondary purchases

Private equity investments are generally considered illiquid. There are no public stock exchanges, as there are for publicly traded securities, on which to buy and sell interests in private equity funds. However, a small secondary market for these interests has developed over the years, giving investors the chance to sell if they desire to. This, in turn, has led to the creation of additional investment opportunities for individual and institutional investors.

A small group of private equity firms specialize in purchasing secondary interests in private equity partnership interests. Managers of secondary funds are not altogether different from those of funds of funds. They don't generally invest directly in companies, but rather in the private equity funds managed by buyout firms or venture capital firms. The big difference is that they are buying their interests in a fund after the fund has been at least partially deployed in underlying portfolio companies. So unlike fund of fund managers, which generally invest in blind pools, secondary buyers can evaluate the underlying companies that they are indirectly investing in.

Commonly asked questions about private equity

How are private equity funds structured? Private equity funds typically are structured as private limited partnerships. The individual managers of a fund make up the general partner. The providers of capital—the individual and institutional investors—are the limited partners. Elaborately detailed private equity partnership agreements signed by the parties involved govern the actions, and carve out the roles, of both the general and limited partners. For example, most partnership agreements allow for the general partner to draw down capital as needed for individual investments, rather than establishing a fixed timetable for draw-downs. Agreements typically provide for an investment period of five to seven years, and for a partnership term of 10 to 12 years, at the end of which any remaining holdings in the portfolio are liquidated, and the cash and stock are distributed to the limited partners.

How do investments in private equity funds differ from those in public securities? The main difference is that private equity investments are illiquid. Limited partners in a private equity fund agree to make their capital commitments available for draw-downs by the general partner over a period of five to seven years. There is no public exchange for the trading of limited partnership interests. Although some firms specialize in buying secondary interests in limited partnerships, such firms generally demand an illiquidity discount that cuts into the returns of the seller. Depending on how skillfully the general partner invests, limited partners begin receiving cash or stock distributions a few years into the life of a partnership. They generally won't receive their final distributions until the last years of what typically is a 10-year partnership term.

How are fund managers compensated? The general partner has two main sources of income. One is the annual management fee, which is calculated as a percentage of total capital commitments to the fund—generally in the 1.5 percent to 2.5 percent range. The second is the carried interest, or share of profits. Traditionally, the carried interest has been 20 percent. However, in recent years, several top-performing venture capital firms have raised their carried interests to 25 percent, or even 30 percent. In some cases, the general partner will guarantee a minimum internal rate of return to the limited partners before sharing in profits. This is referred to as a preferred return. The preferred return is a far more common feature of buyout funds than it is of venture capital funds.

Why do institutional and wealthy individual investors generally allocate a portion of their portfolios to alternative assets such as private equity? Private equity is considered to be a high-risk, high-return asset class that, in moderation, can enhance the overall return of a well-diversified investment portfolio. Studies also have shown that private equity returns don't correlate closely with returns from other asset classes, such as bonds and public equities. Having an allocation to private equity therefore can help smooth out the returns of a balanced portfolio. Institutional investors generally set target allocations to private equity of anywhere from 1 percent to 25 percent, depending on their appetite for risk and their need for liquidity.

What are the minimum requirements to invest in a private equity fund? The minimum commitments that private equity firms set for their funds generally run from $1 million to $25 million or more. Typically, they range from $5 million to $10 million. Fund of fund managers generally set minimum commitments in the $250,000 to $500,000 range for individuals, and significantly higher for institutions. At their discretion, general partners can make exceptions to these minimum commitments, and they often do. Amendments made in 1996 to The Investment Company Act of 1940 give private equity firms an incentive to accept individual investors if they have investable assets of $5 million or more, and institutional investors if they have investable assets of $25 million. The incentive is that private equity firms can accept up to 499 so-called "qualified investors" as limited partners in their partnerships; otherwise, they can accept a maximum of 99 limited partners. Under Regulation D of the Securities and Exchange Commission's rules, which govern the private placement of funds, private equity firms under most circumstances can't have more than 35 unaccredited investors as limited partners. To be accredited, an individual investor must have a net worth of $1 million (or joint net worth with spouse), or have made at least $200,000 in each of the prior two years (or joint income with spouse of at least $300,000), and have a reasonable expectation of making at least the same amount the next year.

Terms commonly used in the field of private equity

Angel investor .... A person who provides backing to very early-stage businesses or business concepts. Angel investors are typically entrepreneurs who have become wealthy, often in technology-related industries.

Board seats .... Venture firms often acquire positions on the board of directors of their portfolio companies. A board seat gives a venture firm a means of monitoring and managing a company they invest in.

Boiler plate .... Standard paragraphs in venture capital and investment documents.

Bricks and mortar .... A company's assets.

Bridge financing .... As the name implies, bridge financing is intended as temporary funding that eventually will be replaced with permanent capital. In some cases, lenders will provide buyout firms and venture capital firms with bridge loans so that they can begin investing, before they have closed on capital for their funds. Likewise, a buyout or venture firm might provide a portfolio company with a temporary financing until permanent financing is in place.

Buy-sell .... An agreement that states under which circumstances one party of an investment must buy out the other party.

Capital take-down .... The schedule by which the general partner of a funds draws down capital from the limited partners to be used for investments. Most general partners today call down capital only as they require it, rather than in pre-set amounts according to a rigid timetable.

Carried interest .... The general partner's share of the profits generated through a private equity fund. The carried interest, rather than the management fee, is designed to be the general partner's chief incentive to strong performance. A 20 percent carried interest—meaning that the remaining 80 percent reverts to the limited partners—has been the industry norm, although some firms now take 25 percent or even 30 percent, based on very strong performance on past funds.

Catch-up .... This is a common term of the private equity partnership agreement. Once the general partner provides its limited partners with their preferred return, if any, it then typically enters a catch-up period in which it receives the majority or all of the profits until the agreed upon profit-split, as determined by the carried interest, is reached.

Closing .... When the legal documents binding the company to the venture capitalist are signed.

Co-investor .... Although used loosely to describe any two parties that invest alongside each other in the same company, this term has a special meaning in relation to limited partners in a fund. By having co-investment rights, a limited partner in a fund can invest directly in a company also backed by the fund managers itself. In this way, the limited partner ends up with two separate stakes in the company; one, indirectly, through the private equity fund to which the limited partner has contributed; another, through its direct investment. Some private equity firms offer co-investment rights to encourage limited partners to invest in their funds.

Consolidation .... Also called a leveraged rollup, this is an investment strategy in which an LBO firm acquires a series of companies in the same or complementary fields, with the goal of becoming a dominant regional or nationwide player in that industry. In some cases, a holding company will be created, into which the various acquisitions will be folded. In other cases, an initial acquisition may serve as the platform through which the other acquisitions will be made.

Control .... Owning or controlling the majority of a company's voting stock.

Convertible debt .... A loan that can be converted into stock or other equity.

Covenant .... Paragraphs in the legal contract stating what will and will not be done in the business.

Debenture .... A debt instrument, such as a loan or promissory note.

Debt service .... The amount of money required annually to repay a debt.

Default .... When a contract covenant is broken or a loan goes unpaid.

Downside risk .... Under worst case conditions, how much the investor could lose.

Due diligence .... The venture capital company's detailed research of the business, the management team and other factors to insure their accuracy, completeness and soundness.

Equity .... Share or portion of ownership, usually denoted by shares of stock in a corporation.

Exit .... The sale of ownership or equity in a business.

General partner clawback .... This is a common term of the private equity partnership agreement. To the extent that the general partner receives more than its fair share of profits, as determined by the carried interest, the general partner clawback holds the individual partners responsible for paying back the limited partners what they are owed.

General partner contribution .... The amount of capital that the fund manager contributes to its own fund in the same way that a limited partner does. This is an important way in which limited partners can ensure that their interests are aligned with those of the general partner. The U.S. Department of Treasury recently removed the legal requirement of the general partner to contribute at least 1 percent of fund capital. However, a 1 percent general partner contribution remains common, particularly among venture capital funds.

Grace period .... The amount of time allowed to cure a default.

Incubator .... An entity designed to nurture business concepts or new technologies to the point that they become attractive to venture capitalists. An incubator typically provides both physical space and some or all of the services—legal, managerial, technical—needed for a business concept to be developed. Incubators often are backed by venture firms, which use them to generate early-stage investment opportunities.

Initial public offering (IPO) .... When a privately held company—owned, for example, by its founders and its venture capital investors—offers shares of its stock to the public.

Lead investor .... The firm or individual that organizes a round of financing, and usually contributes the largest amount of capital to the deal.

Leveraged buyout (LBO) .... The acquisition of a company in which the purchase is leveraged through loan financing, rather than being paid for entirely with equity funding. The assets of the company being acquired are put up as collateral to secure the loan.

Leveraged roll-up .... See consolidation.

Limited partners .... Institutions or individuals who contribute capital to a private equity fund. Limited partners typically are pension funds, private foundations, and university endowments. However, private equity firms themselves may serve as limited partners in other firms' funds, as, for example, when a large buyout firm channels money to a fund managed by a venture capital firm. See also general partner.

Limited partner clawback .... This is a common term of the private equity partnership agreement. It is intended to protect the general partner against future claims, should the general partner or the limited partnership become the subject of a lawsuit. Under this provision, a fund's limited partners commit to pay for any legal judgment imposed upon the limited partnership or the general partner. Typically, this clause includes limitations on the timing or amount of the judgment, such as that it cannot exceed the limited partners' committed capital to the fund.

L.P. .... Limited Partnership.

Management buyout .... The acquisition of a company by its management, often with the assistance of a private equity investor.

Market capitalization .... The overall value of a publicly traded company, derived by multiplying the total number of shares by the share price.

Mezzanine fund .... Used to provide a middle layer of financing in some leveraged buyouts, subordinated to the senior debt layer, but above the equity layer. Mezzanine financing shares characteristics of both debt and equity financing.

Management fee .... This annual fee, typically a percentage of limited partner commitments to the fund, is meant to cover the basic costs of running and administering a fund. Management fees tend to run in the 1.5 percent to 2.5 percent range, and often scale down in the later years of a partnership to reflect the reduced workload of the general partner. The management fee is not intended to be the primary source of incentive compensation for the investment team. That is the job of the carried interest.

PIPEs .... An acronym for "private investing in public equities." See private placement.

Placement agent .... An outside firm hired by a general partner to market its fund to institutional investors. The general partner typically pays a 2 percent fee of the capital raised from new sources by the placement agent.

Portfolio company .... A company in which a venture capital firm or buyout firm invests. All of the companies currently backed by a private equity firm can be spoken of as the firm's portfolio.

Preferred return .... The preferred return is a minimum annual internal rate of return sometimes promised to the limited partners before the general partner shares in profits. In effect, the preferred return ensures that the general partner shares in the profits of the partnership only to the extent that the investments perform well. Once the preferred return is met, there is often a catch-up period in which the general partner receives the majority or all of the profits until it reaches the agreed upon profit-split, as determined by the carried interest.

Preferred stock .... This is one of the most common classes of shares for venture capital and buyout firms to hold. Preferred stock pays dividends at a set rate, and holders get paid before common stock holders in the event of a liquidation. Convertible preferred stock is convertible into common stock at a pre-determined price per share.

Private equity advisor .... An outside firm hired by an institutional investor, such as a state retirement system, to handle the selection, negotiation and monitoring of private equity funds. An advisory assignment can be non-discretionary, in which the institutional investor retains the final say on investment decisions, or discretionary, in which the advisor has the legal authority to make investment decisions on the client's behalf.

Private placement .... This term is used specifically to denote a private investment in a company that is publicly held. Private equity firms that invest in publicly traded companies sometimes use the acronym PIPEs to describe the activity—private investing in public equities. Occasionally, private investors will acquire 100 percent of the shares of a publicly traded company, a process known as a "going-private" deal.

Public offering .... When shares of stock are sold to the public on the open market.

Representations .... Information the investee believes to be true and provides to the investor.

Seed-stage fund .... A pool of money used to back companies too small to attract mainstream venture firms.

Small Business Investment Company .... A licensed member of a U.S. Small Business Administration program that entitles an investment firm to obtain matching federal loans for its private equity investments. Typically, a firm will have access to $2 in credit for every $1 that it invests in a company. If an SBIC raises $20 million, it will have access to up to $40 million in low-interest loans, drawn down on a deal-by-deal basis.

Spin out .... A division or subsidiary of a company that becomes an independent business. Typically, private equity investors will provide the necessary capital to allow the division to "spin out" on its own; the parent company may retain a minority stake.

Stock option .... The right to purchase stock in a company, usually at a pre-established price or formula.

Strategic investment .... An investment that a corporation or affiliated firm makes in a young company that offers to bring something of value to the corporation itself. The aim may be to gain access to a particular product or technology that the start-up company is developing, or to support young companies that could become customers for the corporation's products. In venture capital rounds, strategic investors typically are sometimes distinguished from financial investors—venture capitalists and others who invest primarily with the aim of generating a large return on their investment.

Syndication .... The sharing of an investment among several venture capital organizations.

Turnaround .... A company that is in trouble financially or operationally, but is returned to profitability with an infusion of capital and/or management assistance.

Underwriter .... The brokerage house that raises money for a business in a public offering.

Upside potential .... The maximum profit the investor could make from an investment.

Venture capital rounds .... Portfolio companies typically receive several rounds of venture capital before going public. The first round is usually smaller than subsequent rounds, and likely to involve fewer investors. Note that first-round funding does not necessarily mean that the company has received no previous outside backing. The term "first round" is still appropriate if previous backing consisted of, say, $500,000 from an angel investor. A first round typically is the first round involving participation by a venture capital firm.

Warrant .... An option to purchase stock in a company, typically exercised over an extended period.

Warranties .... True items about a business told to an investor or venture capitalist.

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Definitions of Profile Terms

Below and on the following pages are definitions and explanations of terms used in the profiles in this directory.

Funding Stage Preference Options

Seed .... Concept or idea stage. Money needed to research market and concept feasibility.

R&D .... Financing the research & development of a new technology or product.

Startup .... Pre-operational financing of a new business.

First-stage .... The business is operational but needs capital to hire employees, purchase equipment, and roll out product and marketing program.

Second-stage .... Initial sales results are encouraging. Now, additional capital is needed to expand production and marketing.

Mezzanine .... In a start-up company, this is the round of equity financing that immediately precedes an initial public offering. In a Leveraged or Management Buyout, this is a layer of subordinated debt below the senior debt but above the equity.

Bridge .... Temporary financing between major funding rounds.

Consolidation .... A strategy of acquiring several companies in the same line of business to build a large industry leader.

Acquisition .... Purchase of another company, facility, etc.

Leveraged Buyout .... Purchase of an established company by an outside party using the company's assets as the collateral for a loan used to finance the acquisition.

Management Buyout .... Purchase of an operation by its management, often with the assistance of a venture capital or private equity firm.

Recapitalization .... The restructuring of a company's balance sheet by either increasing or decreasing the amount of corporate debt.

Special Situations .... Opportunities that don't fit within an established category.

Bankruptcy .... Investment in a company that has sought legal protection from creditors in bankruptcy court.

Distressed Debt .... The purchase of senior or junior debt instruments or trade credits of a company in financial difficulty, though the company might not yet have filed for bankruptcy protection.

Franchise Funding .... Financing of a franchised business.

Privatizations .... The sale to private owners of a company previously owned by a government body.